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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No.[redacted] 94

FRED T. HOGAN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI

to the United States Circuit Court of Appeals For the Fifth Circuit

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TO THE HONORABLE THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The petitioner, Fred T. Hogan, prays that a writ of certiorari issue to review that part of the opinion and judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered February 25, 1944, wherein it was held that petitioner did not make a sale of an interest in an oil and gas leasehold estate, and that he is not entitled to treat the resulting profit as long-term capital gain under Section 117 of the INTERNAL REVENUE CODE.

Opinions Below

The Memorandum Opinion of The Tax Court of the United States (R. 91-93) is unreported. The Opinion of the Circuit Court of Appeals (R. 121) is reported at 141 Fed. (2d) 92.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240(a) of the JUDICIAL CODE as amended by the Act of February 13, 1925. The Opinion and Judgment of the court below was entered February 25, 1944 (R. 121).

Question Presented

1. Where an interest in an oil and gas lease is assigned and the assignor retains and does not sell a fractional interest in the oil and gas in place, is this a sale and the profit capital gain under Section 117 of the REVENUE ACT OF 1938 (App. p. 13), or is it a sublease and the profit ordinary income under Section 22 of said Act? (App. p. 12).

Statute and Regulations Involved

The statutes and regulations involved will be found in the Appendix, infra, pp. 12 to 15.

Statement

This is a companion case with CHOATE v. COMMISSIONER and COMMISSIONER v. CHOATE (C.C.A., 10th Circuit Court of Appeals, decided March 13, 1944), —Fed. (2d) —. There is a conflict on one point between the decision of the Circuit Court of Appeals for the Fifth Circuit in this case and the decision of the Tenth Circuit Court of Appeals in the case of

COMMISSIONER v. CHOATE. A petition for writ of certiorari is being filed simultaneously herewith in the cases of CHOATE v. COMMISSIONER and COMMISSIONER v. CHOATE. The petitioner was a member of the same partnership of which Choate was a member and the tax liability involved in this case and in the CHOATE cases arises out of the same transaction.

On December 18, 1936, petitioner acting for himself and L. H. Choate and W. G. Choate, acquired an oil and gas lease by assignment from one Roy R. Brown. The lease had been originally executed by Mrs. M. L. Baker, the fee owner, and covered a tract of land situated in Upton County, Texas. After the lease was acquired from Brown, a partnership was formed under the name of Choate & Hogan to own, develop and operate the property for the production of oil and gas. Petitioner owned a one-half interest in the said partnership. Subsequently, the partnership developed the Baker lease by drilling six producing oil wells thereon. Said wells were completed prior to October 11, 1938. On the latter date, Choate and Hogan, acting for the partnership, entered into a written contract (R. 71) to sell the lease to McAlester Fuel Company, for a cash consideration of \$110,000 to be paid by the buyer, and the contract further provided that the sellers were to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8th of 8/8ths of all oil and gas produced and saved from the lease by the buyer. On August 22, 1938, Choate & Hogan executed an assignment (R. 28) of the lease, together with all the equipment thereon, to the Sylva Oil Company (nominee of McAlester Fuel Company, R. 64), and in said assignment it was provided, among other things, that "assignors herein expressly reserve to themselves, their heirs and assigns, and *do not assign or convey* to the assignee herein, 1/8th of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by the Sylva Oil Company."

In the partnership return filed by Choate & Hogan for the year 1938, the profit from the sale of the property was reported as long-term capital gain pursuant to Section 117 of the REVENUE ACT OF 1938. The respondent determined that the transaction with the Sylva Oil Company was a sublease rather than the sale of a capital asset and that the profit could not be treated as long-term capital gain. He treated the cash consideration of $110,000 as a lease bonus, allowed depletion thereon at the rate of 27½% (Sec. 114(b) (3) of the REVENUE ACT OF 1938, App. p. 13), and taxed the remainder as ordinary income under Sec. 22(a) of said Act (App. p. 12).

In his computation, respondent made no allowance for the undepreciated cost of the equipment ($23,090.60), which was on the lease at the time of sale and held that such undepreciated cost was recoverable through depletion allowances applicable to production from the retained interest of ⅛th of 8/8ths.

The Tax Court held (1) that petitioner was not entitled to treat the transfer of the interest in the lease as a sale, but must look to depletion for the return of his capital; and (2) that the unrecovered cost of the equipment on the lease at the time of the transfer is to be deducted in full from the cash consideration in determining the amount of gain subject to the depletion allowance (R. 91-93).

Both the petitioner and the Commissioner appealed and the United States Circuit Court of Appeals for the Fifth Circuit sustained The Tax Court on both points (R. 121). In the companion cases of W. G. Choate v. Commissioner and Commissioner v. W. G. Choate, supra, the Circuit Court of Appeals for the Tenth Circuit affirmed The Tax Court on the first point and reversed it on the second.

Specification of Error to Be Urged

1. The court below erred in holding that petitioner did not make a sale of a part of his interest in the Baker lease and that the gain realized is not taxable as long-term capital gain under Sec. 117 of the *Revenue Act of 1938* (App. p. 13).

Reasons Relied Upon for the Granting of the Writ

FIRST. There is a direct conflict between the decision of the Fifth Circuit Court of Appeals in this case and the decision of the Tenth Circuit Court of Appeals in the case of COMMISSIONER v. CHOATE, supra, on the question of whether the cost of the equipment on the lease at the time of the transfer is deductible from the cash consideration of $110,000 in computing the gain. The Fifth Circuit Court of Appeals held that the cost of the equipment is deductible from the cash consideration; the Tenth Circuit Court of Appeals held that it is not so deductible.

Both the Fifth and Tenth Circuit Courts of Appeal held that the taxpayers were not entitled to treat the transfer of the interest in the lease as a sale and the resulting profit as long-term capital gain. Each of said courts held that the taxpayers' rights are determinable by depletion. The interest in the lease and the equipment were disposed of as a unit in a single transaction. By the terms of the sales contract the sellers agreed to sell an interest in the lease together with all equipment thereon and title to the interest in the lease and the equipment on the lease was conveyed by a single instrument of assignment. Should this Court grant the petition for writ of certiorari which has been applied for in the case of Commissioner v. Choate, the decision in which is in conflict with the decision of the Fifth Circuit in this case, it will necessarily be required to examine and construe both the contract of

sale and the assignment, and no additional burden will be imposed on this Court if it also undertakes to review the decision of the Fifth Circuit Court of Appeals in this case on the issue as to whether the transaction was a sale or a sublease. As hereinafter pointed out this is a question of first importance to the oil industry as a whole, and the Court is respectfully urged to grant this petition and review the decision of the Fifth Circuit Court of Appeals on said issue.

SECOND. Approximately sixty-five per cent of the known oil reserves in the United States are located in the States of Texas, Louisiana and Mississippi, which States are included within the Fifth Judicial Circuit of the United States. There are also substantial oil reserves in certain of the States embraced within the Tenth Circuit, such as Oklahoma, New Mexico and Colorado. Assignments of oil and gas leases are made in said States practically every day in the year. A customary practice in the industry is for the assignee to pay the assignor a cash consideration with the assignor retaining an overriding royalty or an oil payment in a certain amount payable out of a fraction of the production. An important question of Federal law which has not been, but should be settled by this Court arises in the case of each of such assignments, namely: for Federal tax purposes, are transactions of such character sales of capital assets, and do they give rise to capital gains or losses which are limited by Section 117 of the REVENUE ACT OF 1938 (App. p. 13), or are they so-called subleases, the gain and loss on which is recognizable in full for Federal tax purposes? The Fifth Circuit Court has arbitrarily held that the transaction is a sale if an oil payment is retained by the vendor but that it is a sublease where the retained interest is stated in terms of an overriding royalty. CULLEN v. COMMISSIONER, 118 Fed. (2d) 651; WEST PRODUCTION CO. v. COMMISSIONER, 121 Fed. (2d) 9; MCLEAN v. COMMISSIONER, 120 Fed. (2d) 942; FLEMING v. COMMISSIONER, 82

Fed. (2d) 324; ROESER & PENDLETON, INC., v. COMMISSIONER, 118 Fed. (2d) 462 (all by C.C.A. 5th). The Tenth Circuit Court of Appeals made the same distinction, COMMISSIONER v. LEWIS, 142 Fed. (2d) 709, and CHOATE v. COMMISSIONER, — Fed. (2d) —. These rulings have been made notwithstanding it is the settled law of Texas that an oil payment and overriding royalty are each real property of like kind and character. STATE, ET AL., v. QUINTANA PETROLEUM CORP., ET AL. (Supreme Ct. of Texas), 134 Tex. 179, 133 S.W. (2d) 112; SHEPPARD v. STANOLIND OIL & GAS CO. (Austin Ct. of Civil Appeals, writ of error refused), 125 S.W. (2d) 643. Thus the distinction made by the Fifth and Tenth Circuit Courts between an oil payment and an overriding royalty is a distinction without a difference. See also LEE v. COMMISSIONER (Fifth C.C.A.), 126 Fed. (2d) 825, where it was held that oil payments and overriding royalties are to be treated alike for depletion purposes.

The effect of the decisions of the Fifth and Tenth Circuits has been to deprive taxpayers of the special benefits accorded them by the statutes relating to taxation of capital gains, which statutes were intended to be and are remedial in character. Under the said decisions, a taxpayer cannot make a sale of an oil and gas lease and secure taxation of the gain at capital gain rates if he retains an interest in the form of an overriding royalty, and this is true notwithstanding every essential element of a sale is present in the transaction, namely (1) Parties competent to contract; (2) mutual assent; (3) a thing, the absolute or general property in which is transferred from the seller to the buyer; and (4) a price in money paid or promised. (BUTLER v. THOMSON, 92 U.S. 412.) Thus, the question is of the utmost importance to the vast number of taxpayers who own oil and gas leases. The question is also important from the standpoint of the Treasury because under the decisions of the Fifth and Tenth Circuits,

as they now stand, a taxpayer owning an oil and gas lease can effect a transfer of it in a manner which will permit him to control the amount of gain or loss thereon which will be recognizable for tax purposes.

THIRD. This Court has affirmed and reaffirmed the doctrine that in tax matters substance always controls over form. U. S. v. PHELLIS, 257 U.S. 156; HELVERING v. TEX-PENN OIL CO., 300 U.S. 481;SMITH v. HIGGINS, 308 U.S. 561; and GRIFFITHS v. HELVERING, 308 U.S. 355. The Circuit Court of Appeals for the Fifth and Tenth Circuits in the cases cited, supra, applied an arbitrary rule of thumb or yardstick in determining whether the transactions were sales or subleases. If the reservation was in the form of an oil payment, the transaction was held to be a sale; if stated in terms of an overriding royalty, the transfer was held to be a sublease. Thus, the decisions were made to turn entirely and exclusively on the type of reservation that was contained in the instrument of conveyance. Form and form alone has been the dominating and decisive guidepost followed in rendering the said decisions and judgments. The type of reservation has been applied as an all-exclusive test in determining the nature of the transaction. Proof of this fact is ably demonstrated by the incongruous results reached in CULLEN'S case where despite the fact that the twelve leases were conveyed by a single instrument in a single transaction, the Fifth Circuit held as to the nine leases in which overriding royalties were retained that the transfers were subleases, and as to the three leases in which oil payments were retained that the transfers were sales. The court below has given no heed whatever to the substance of what was done. Accordingly, its decision and judgment conflict in principle with the settled law established by this Court that in applying our tax laws the courts will not exalt form over substance.

FOURTH. The decision of the court below is also believed to be in conflict in principle with the decision of this Court in THOMAS v. PERKINS, 301 U.S. 655. In such case, an oil and gas lease was conveyed to the taxpayer for a cash consideration plus a sum to be paid out of the oil produced and saved from the lands. The Collector sought to tax the assignee with the amounts paid by him over to the assignor on the oil payment. This Court held that the fraction of the oil required to liquidate the oil payment did not pass to the assignee by virtue of the terms of the assignment and that such fraction of the oil reserves had been retained by and belonged to the assignor, and that the assignee was not taxable on the proceeds therefrom. Although this Court did not pass directly on the question of whether the assignor had made a sale of the fraction of the oil that passed to the assignee, it did recognize that a taxpayer owning an oil and gas lease can make a sale of a fractional interest therein and retain a fractional interest. The court below has refused to treat and recognize as a sale a transfer of a lease if an overriding royalty is retained by the transferor and its decision is probably in conflict with the decision of this Court in THOMAS v. PERKINS, supra.

FIFTH. Before the Revenue Act of 1921 gains realized from the sale of property were taxed at the same rates as other income with the result that capital gains often accruing over a long period of time were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provision of the 1921 Revenue Act for taxing capital gains at a lower rate, reënacted in one form or another in all subsequent Revenue Acts, were "*adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments and to remove the deterrent effect of those burdens on such conversions.*" BURNETT v. HARMEL, 287 U.S.

103, and HOUSE REPORT NO. 350, WAYS AND MEANS COMMITTEE, 67th Congress, First Session, on the Revenue Bill of 1921 (App. p. 14).

It is clear from this Court's decision in the HARMEL case and the Report of the Committee on Ways and Means that the new provision of the Revenue Act of 1921 taxing capital gains at a lower rate than ordinary income was taxed was intended as a relief measure. This Court has repeatedly held that relief statutes are to be construed liberally in favor of taxpayers in order that they will receive the benefit of the relief the statutes were intended to provide. BONWIT TELLER & Co. v. U. S., 283 U.S. 258; U. S. v. MERRIAM, 263 U.S. 179; BOWERS v. NEW YORK & ALBANY LIGHTERAGE CO., 213 U.S. 346; U. S. v. UPDYKE, 281 U.S. 489; and BURNETT v. NIAGARA FALLS BREWING CO., 282 U.S. 648.

The gain involved in this proceeding resulted from the conversion of a capital asset, namely: an interest in an oil and gas lease on which there were six producing oil wells at the time of the transfer. The lease had been held by the partnership for the requisite length of time for the gain on the transfer to be taxed as long-term capital gain. All of the gain did not accumulate in the year of realization. It accrued over the period of time the lease was held and owned by the partnership. If the gain is treated as ordinary income, 100% of it will be taxable; whereas, if it is treated as long-term capital gain, only 60% will be includible in income. If the gain is treated as ordinary income, it will fall in a higher surtax bracket than it would if treated as long-term capital gain; consequently, petitioner is within that class of taxpayers which the capital gain provisions were intended to reach and benefit by relieving them from excessive surtax burdens when a capital asset is converted at a profit.

Notwithstanding the above situation, the court below held that the petitioner was not entitled to *treat* the transaction as

a sale. In doing so, the court has not construed the statutes liberally in petitioner's favor. On the contrary, the statute has been construed most liberally in favor of the Government. Thus it appears that the court below has violated the principle long since settled by the decisions of this Court that relief statutes are to be given a liberal construction in favor of taxpayers in order to give them the relief the statutes were intended to provide.

It is respectfully submitted that this petition should be granted.

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Appendix

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Sec. 23. Deductions From Gross Income.

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. * * *

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Sec. 114. Basis for Depreciation and Depletion.

(b) (3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under Section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23 (m) be less than it would be if computed without reference to this paragraph.

Sec. 117. Capital Gains and Losses.

(a) (1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23 (l).

(a) (4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income.

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

House Report No. 350. Ways and Means Committee on the Revenue Act of 1921.

"The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transaction to go forward without fear of a prohibitive tax, the proposed bill, in Section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue,

not only because it would stimulate profit-taking trans-actions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

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OPINIONS BELOW

The opinion of the Tax Court (R. 82–93) is not officially reported. The opinion of the circuit court of appeals (R. 120–126) is reported in 141 F. 2d 92.

JURISDICTION

The judgment of the circuit court of appeals was entered on February 25, 1944 (R. 126–127). Petition for a writ of certiorari was filed May 23, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a transfer in 1938 of an interest in a producing oil and gas leasehold together with the equipment thereon, for a cash consideration and the retention of an overriding royalty, was a sublease resulting in ordinary income under Section 22 (a) of the Revenue Act of 1938, as the Commissioner contends, or a sale giving rise to capital gain under Section 117 of the Act, as the petitioner contends.

STATUTE AND REGULATIONS INVOLVED

The pertinent sections of the statute and regulations are set forth in the Appendix, *infra*, pp. 11–13.

STATEMENT

The material facts as found by the Tax Court (R. 83–91) may be stated as follows:

In 1936, petitioner and L. H. Choate acquired an interest in the "Baker lease," consisting of the oil, gas, and casinghead gas, and rights thereto, at and above a certain depth from the surface in and under 230 acres of land in Upton County, Texas. The lease was subject to a $\frac{1}{8}$th royalty interest retained by the original lessor, an overriding royalty in Continental Oil Company of $\frac{1}{16}$th of all oil, gas, or casinghead gas produced, saved, and sold from depths not exceeding a certain depth from the surface, and $2,500 payable to the immediate assignor out of $\frac{1}{8}$th of $\frac{13}{16}$ths of all oil produced and saved from the property if, as, and when produced. (R. 83–84.)

In acquiring the interest in the Baker lease, petitioner and L. H. Choate were acting for themselves and for W. G. Choate. These parties then organized a partnership known as Choate & Hogan, of Midland, Texas, to own, develop, and operate the interest in the Baker lease. The partnership drilled six wells on the lease. (R. 84–85.)

On August 11, 1938, the partnership entered into a written contract covering the Baker lease with the McAlester Fuel Company, in which the partnership was designated as "seller" and the McAlester Fuel Company as "buyer." Under the contract the partnership was to execute and deliver an assignment of the lease to the McAlester Fuel Company, for a consideration of $110,000 in cash. The partnership was "to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8th of 7/8ths of all oil and gas produced" by the McAlester Fuel Company, its successors, or assigns. By agreement between the parties the contract of purchase of the lease was to be carried out by execution of an instrument of conveyance to the Sylva Oil Company, instead of to the McAlester Fuel Company. (R. 86.)

On August 22, 1938, the Sylva Oil Company notified L. H. Choate that it had purchased the lease, "together with the producing oil wells thereon and the equipment of such wells, including the house on the lease" (R. 86). On the same

date Choate and petitioner executed an instrument (R. 86–87) by which they did "bargain, sell, assign and convey," subject to all the terms of the instrument under which it was acquired by the partnership, all of the partnership's right, title and interest in the property.

> together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage, to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignor herein expressly reserve to themselves, their heirs and assigns, and do not assign or convey to the assignee herein, $\frac{1}{8}$th of the $\frac{8}{8}$ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred fifty feet from the surface under and by virtue of the lease above mentioned, delivery of such part of the oil, gas and casinghead gas to be made free of cost to the assignors * * *; such reservation of overriding royalty or share of production to be $\frac{1}{16}$th of the $\frac{8}{8}$ths in favor of L. H. Choate, and $\frac{1}{16}$th of the $\frac{8}{8}$ths in favor of Fred T. Hogan.

At the date of the transaction with Sylva Oil Company the interest in the Baker lease owned by Choate and petitioner consisted of $\frac{13}{16}$ths of

$^{8}/_{8}$ths, the \$2,500 oil payment having been paid out during March 1938. The cost, less depletion sustained, of this interest to the partnership was \$23,583.78 on that date. (R. 87.)

After the assignment Sylva Oil Company drilled and paid for four additional oil wells and operated the lease, and the parties otherwise conformed to the terms of the instrument. Neither the Choates nor petitioner understood that they had any rights as landlord. Sylva Oil Company certified and guaranteed to Humble Oil Company that effective 7:00 A. M. on August 15, 1938 (the effective date of the last transaction) it was the legal owner of a $^{7}/_{8}$ths interest in the oil produced from the property covered by the Baker lease, subject to overriding royalties of $^{1}/_{16}$th each to Continental Oil Company, L. H. Choate, and petitioner. (R. 87–88.)

The transaction involved was reported in the partnership return of Choate & Hogan for the year 1938 as a sale, as follows (R. 88–89):

	Leasehold	Equipment	Total
Sale Price	\$98, 454. 70	\$11, 545. 30	\$110, 000. 00
Less Cost of Sale:			
Gross Cost	33, 391. 80	30, 206. 49	63, 598. 29
Less—Reserves for Depletion and Depreciation	9, 808. 02	7, 115. 89	16, 923. 91
Net Cost of Sale	23, 583. 78	23, 090. 60	46, 674. 38
Gross Gain from Sale	74, 870. 92	(11, 545. 30)	63, 325. 62
Less Commission Paid	3, 000. 00		3, 000. 00
Net Gain from Sale	71, 870. 92	(11, 545. 30)	60, 325. 62
Taxable Gain from Sale (Sec. 117, Revenue Act of 1938)	\$47, 913. 95	(\$11, 545. 30)	\$36, 368. 65

The loss of $11,545.30 as computed on the sale of equipment was reported as an ordinary loss. The net gain from the sale of the leasehold of $71,870.92 was reported as a long-term capital gain under Section 117 of the Revenue Act of 1938 (Appendix, *infra*), taxable to the extent of $47,913.95. The above gain and loss were reported in the individual returns of the partners in accordance with their partnership interests. (R. 89.)

In his notice of deficiency the Commissioner determined that the partnership did not make a sale of the Baker lease but held that the transaction constituted a sublease, the initial cash payment of $110,000 being a bonus. The Commissioner computed the gain on the transaction as follows (R. 89):

Oil income		$110,000.00
Less:		
Depletion	$30,250.00	
Commissions	3,000.00	33,250.00
		$76,750.00

The Tax Court held with the Commissioner that the transfer by the partnership of its interests in the lease was a sublease and not a sale, and that the partnership must recover its capital investment therein through depletion allowances. With respect to the equipment, however, the Tax Court followed the view of the petitioner, and held that the unrecovered cost of the equipment could be deducted from the cash consideration received. (R. 91–92.) The circuit court of appeals affirmed

the Tax Court on both of these issues (R. 124–126).

ARGUMENT

There is no occasion for further review of this case. The issue which petitioner seeks to have redetermined here was decided below upon uniformly accepted principles of law established long since by this Court and by it frequently reiterated.[1] And the asserted "conflict" which is claimed (Pet. 5) as an *inter alia* basis for issuance of the writ does not relate to any matter which was decided below adversely to the petitioner: it concerns only the holding of the courts below with respect to the deductibility of the cost of the equipment—an issue which was decided in petitioner's favor.

There can be no question but that the assignment by the partnership of a part of its leasehold interest for a cash bonus and an overriding royalty resulted in a sublease rather than a sale, and that the partnership could look only to depletion allowances for the return of its capital. The decision of this Court in *Burnet* v. *Harmel,* 287 U. S. 103, a case on all fours with the one at bar, furnishes a complete answer to petitioner's every contention. There, as here, under an instrument providing for overriding royalties with cash

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[1] *Burnet* v. *Harmel*, 287 U. S. 103; *Palmer* v. *Bender*, 287 U. S. 551; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299. See also *Thomas* v. *Perkins*, 301 U. S. 655. And compare *Anderson* v. *Helvering*, 310 U. S. 404.

bonus, the taxpayer recipient sought to have the bonus taxed as gain from the sale of a capital asset rather than as ordinary income subject to depletion allowances. But this Court, decisively rejecting the contention, declared in the *Harmel* case (p. 107) that such transactions are not "sales" of the mineral content of the soil. And this was true, the Court said (p. 109), even though under the law of Texas (the situs both of the *Harmel* well and of the one involved in the case at bar) an oil and gas lease operates instanter to pass to the lessee title to the oil and gas in place. The state law creates legal interests, but the federal statute determines when and how they shall be taxed; and for such purpose the economic consequences of the lease must be considered rather than any particular characterization of the payments in local law. Where the instrument reserves in the lessor the right to share in the oil as produced, there is no conversion of capital as upon the sale of a capital asset. By virtue of the provision for overriding royalties, on which the cash bonus is considered an advance,[2] the lessor retains an economic interest in the gas and oil in place; hence payments representing his share in production are ordinary income to him and he recoups his capital investment through depletion allowances. The situation is fundamentally the

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[2] See Article 23 (m)–10 of Treasury Regulations 101, promulgated under the Revenue Act of 1938 (Appendix, *infra*); *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299.

same as that of a land owner who conducts mining operations upon his own property, and the tax consequences are fundamentally alike. Such is the doctrine of the *Harmel* case; and that doctrine is clearly appropriate to and fully dispositive of this case.[3] The court below correctly so held.

The taxpayer in the *Harmel* case made the same argument with respect to the "relief" purpose of the capital gains provisions as does the taxpayer at bar. But again, as this Court pointed out in the *Harmel* case (p. 106), a transaction of this kind does not call for the "relief" which Congress intended thus to provide. Abstraction of gas and oil is a time-consuming operation, and the payments to the assignor do not normally become payable as the result of a single transaction within the taxable year as in the case of a sale of property; no favored tax treatment is accordingly warranted.[4]

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[3] As in the *Harmel* case, we are here dealing with a true overriding royalty as distinguished from an oil payment transaction. Hence, there is manifestly no need to consider any of the problems raised by petitioner (Pet. 6, *et seq.*) as to whether the Circuit Courts of Appeals for the Fifth and Tenth Circuits have held a sale to result where the retained interest is an oil payment rather than an overriding royalty, whether there is any efficacy to such a distinction, and what is the present decisional status thereof.

[4] Nor is there any merit to petitioner's claim (Pet. 9) that the decision below is probably in conflict with *Thomas* v. *Perkins*, 301 U. S. 655. The *Perkins* case was concerned with whether that part of the proceeds of production which the assignee paid over to the assignor as oil payments was tax-

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted.

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able income to the assignee. The case was decided upon the same basic principles as underlie the decision at bar; the Court there held that since, in the provision for the oil payment, the assignor retained a depletable interest in the oil and gas in place, the proceeds allocable to the retained interest were income to the assignor.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

* * * * *

(m) *Depletion.*—In case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

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SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

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(b) *Basis for Depletion.*—

*   *   *   *   *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

*   *   *   *   *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this title—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

*   *   *   *   *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

$66\frac{2}{3}$ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 23 (m)–10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—

* * * * *

(*d*) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year $27\frac{1}{2}$ percent of the amount thereof; * * * but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

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